**Office of Chief Counsel**
**Internal Revenue Service**

# memorandum

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RHGannon

date: April 2, 2002

to: Internal Revenue Service
[redacted]
Attention: [redacted]

from: RICHARD H. GANNON
Special Litigation Assistant

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subject: [redacted]
**EIN** [redacted]
**Miscellaneous Reorganization Issues**

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This is our response to your recent request for advice regarding the federal income tax implications of various reorganization transactions entered into by the taxpayer in [redacted] and [redacted].

ISSUES:

1. Whether the Merger of [redacted] into [redacted] qualifies as a "A" reorganization where only [redacted]% of the [redacted] stock given up in the exchange was converted into [redacted] shares.

2. Whether the [redacted] sale of the [redacted] stock acquired in the merger breaks the continuity of interest existing immediately after the [redacted] merger.

3. Whether [redacted] was actively engaged in the conduct of a trade or business after the split off of [redacted] when it immediately merged into [redacted] and disappeared as a result of the merger.

4. Whether the [redacted] stock distributed to [redacted] constituted "disqualified stock" within the meaning of I.R.C. § 355(d)(3), thus requiring the recognition of gain on the distribution by [redacted] under § 355(c)(2).

CONCLUSION:

1. The merger of [redacted] into [redacted] met the continuity of shareholder interest test subsumed in the definition of a tax free reorganization under § 368(a)(1)(A) where the former shareholders of [redacted] exchanged their stock for stock in two separate corporations, each of which actively operated a trade or business after the merger, and where at least [redacted]% of [redacted]'s stock was converted into equity interests in the surviving corporation.

2. In the absence of evidence that the [redacted] sale of the [redacted] stock received as a result of the merger was contemplated at the time of the merger, the sale of stock did not break the continuity of interest existing immediately after the merger.

3. [redacted] continued to actively operate a trade or business after the distribution of the [redacted] stock to [redacted] within the meaning of § 355(b)(1) despite the fact that it immediately merged with [redacted] and disappeared as a result of the merger.

3. The [redacted] stock distributed to [redacted] constituted "disqualified stock" because [redacted] had acquired the [redacted] stock surrendered in the exchange after [redacted] and within the five year period immediately preceding the split off. As a consequence, [redacted] should have recognized gain on the distribution in the amount by which the fair market value of the [redacted] stock exceeded [redacted]'s adjusted basis in the assets.

FACTS:

[redacted], (the "Taxpayer" or "[redacted]"), is a wholly owned subsidiary of [redacted]. As more fully discussed below, [redacted] did business under the name [redacted] prior to [redacted]. Its primary business was the [redacted]

[redacted].[1] [redacted] ("[redacted]") was a [redacted]% subsidiary of [redacted], and [redacted] owned [redacted]% of the common stock of [redacted] ("[redacted]"), which operated several businesses, including a [redacted] business and another business operated as a division of [redacted] (the [redacted]), a wholly owned subsidiary of [redacted].

[redacted] acquired its interest in [redacted] in four separate, taxable transactions over a two year period, the first taking place in [redacted] and the last taking place in [redacted].

[redacted], an unrelated public company, owned all of the stock of [redacted], another domestic corporation.

In [redacted], [redacted] and [redacted] entered into a series of transactions with [redacted] and [redacted] culminating in the formation of a new subsidiary of [redacted] ("[redacted]"), the split off [redacted] to [redacted] in return for approximately [redacted]% of [redacted]'s [redacted] shares, and the subsequent merger of [redacted] into [redacted] in return for all of [redacted]'s Class B, non-voting common stock. The total deal was valued at approximately $[redacted] with adjustments to be made as more fully discussed below.

The first major step in the reorganization of [redacted], taking place in [redacted], entailed the reduction of [redacted]'s ownership in [redacted] from [redacted]% to [redacted]%. This was accomplished by the transfer of the [redacted] to a new subsidiary of [redacted], [redacted], in return for all of [redacted]'s stock, the distribution of [redacted]'s stock to [redacted], and the transfer of [redacted]'s stock to [redacted] in return for [redacted]% of [redacted]'s ownership interest in [redacted].[2] According to with [redacted], CFO of [redacted] until [redacted] and current CFO of new [redacted],[3] the [redacted] had been actively

[1] [redacted].

[2] At the outset of the transaction, the [redacted] business was operated as a division of a second tier subsidiary of [redacted], [redacted]. The [redacted] business was dropped into a new company, [redacted], and the stock of [redacted] distributed up the chain (from [redacted] to [redacted]'s first tier subsidiary, [redacted], and from [redacted] to [redacted].) At this point, [redacted] was distributed to [redacted] in redemption of [redacted]% of [redacted]'s [redacted] stock.

[3] In [redacted], [redacted]'s predecessor, also known as [redacted], changed its name to [redacted]. At the same time, [redacted] distributed the historic business operated by [redacted] to a new subsidiary, whose name was promptly changed to [redacted]

engaged in the business of producing and supplying [redacted] for use in the [redacted] industries since the early [redacted]s or before.[4]

As a result of the split off of [redacted], [redacted] surrendered [redacted]% of its [redacted] stock, leaving [redacted] individuals owning [redacted]% of [redacted]'s stock and [redacted], former owner of [redacted]%, owning [redacted]%.

The second major step in the reorganization of [redacted], taking place in [redacted], involved the merger of [redacted] into [redacted], formerly known as [redacted] ("[redacted]"). [redacted]'s shareholders received shares of [redacted]'s' Class B Common Stock, representing [redacted]% of [redacted]'s common shares, and $[redacted] in cash in the exchange.[5] Approximately a third of the stock received for [redacted]'s stock was distributed to [redacted], with the remaining stock and all of the cash distributed to the [redacted] individual shareholders of [redacted].[6]

The merger agreement contained elaborate "put" provisions granting the former [redacted] shareholders options to sell the [redacted] stock received in the exchange back to [redacted] after [redacted] years. The exercise price was based on the valuation placed on the shares under the merger agreement plus interest at the annual rate of [redacted]% beginning on the [redacted] anniversary of the closing date. The agreement also required [redacted] to establish, on the [redacted] anniversary of the closing, a letter of credit to secure a portion of its "put" obligation, adding to the letter of credit on the [redacted], [redacted] and [redacted] anniversary of closing. The final value of the letter of credit was to be [redacted]% of the principal amount of $[redacted], or approximately $[redacted]. The

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[redacted]. [redacted] stayed with the [redacted] operation in [redacted], while [redacted] moved to [redacted].

[4] The undersigned met with [redacted] on [redacted], while visiting the examining agent at the audit site. [redacted] was a very credible witness and a font of knowledge about the [redacted].

[5] The rest of [redacted]'s common stock was owned by [redacted] ("[redacted]"). [redacted]'s stock is traded on the New York Stock Exchange.

[6] The agreed value of [redacted] before the split off of [redacted] was $[redacted]. The agreed value of [redacted] was $[redacted]. After the split off, the remaining value of [redacted] was $[redacted]. The [redacted] shareholders realized approximately $[redacted] in cash and $[redacted] in [redacted] stock as a result of the merger.

merger agreement further precluded the sale of any of the [redacted] shares by the former [redacted] shareholders except in connection with a sale of [redacted] stock to a third party or a public offering of [redacted] shares. Moreover, [redacted] agreed not to sell its [redacted] stock for a period of [redacted] months after closing. [redacted] retained the right to consider unsolicited offers for the purchase of [redacted] "which the board of directors of [redacted] determines is necessary to comply with its fiduciary obligations to [redacted]'s public shareholders."

Some time prior to [redacted], or [redacted] after the merger date, [redacted] was approached by [redacted] with a view to acquiring all of [redacted]'s outstanding stock. On that date, in anticipation of the [redacted] sale, [redacted] entered into an agreement with the former [redacted] shareholders to purchase their shares in contemplation of a merger of [redacted] into [redacted]. Under the terms of the agreement (the "[redacted] Agreement"), [redacted] agreed to buy the [redacted] shares owned by the former [redacted] shareholders for $[redacted], $[redacted] of which was allocable to [redacted]. According to pro-forma return information furnished by the taxpayer's [redacted] office to its new corporate headquarters in connection with the preparation of the taxpayer's [redacted] return, the sale was completed in [redacted], the taxpayer realizing $[redacted] on the sale. The taxpayer apparently reported, or intended to report, all of the amount realized as long term capital gain.[7]

On its tax return for the years in question, Taxpayer treated the above transaction as separate tax free steps in a tax free reorganization, the split off of [redacted] as a reorganization of the type described in I.R.C. § 368(a)(1)(D), and the merger of the remains of [redacted] as a reorganization of the type described in

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[7] [redacted] acquired its [redacted] stock for a total purchase price of $[redacted]. It surrendered approximately [redacted]% of its [redacted] stock in connection with the split off of [redacted]. § 358(b)(2) provides, that in the case of a § 355 exchange, the stock in distributing corporation retained by the transferee is deemed to have been surrendered along with any stock actually surrendered in the exchange and the basis in the deemed surrendered and surrendered stock allocated between the retained stock and the stock of any new company permitted to be received without the recognition of gain or loss. By our figures, [redacted]% of [redacted]'s former basis in its [redacted] stock or $[redacted] should have been allocated to its [redacted] stock, thereby reducing its gain to slightly under $[redacted].

I.R.C. § 368(a)(1)(A).[8]

You have raised several questions regarding the taxpayer's treatment of the above transaction. First, you question whether the sale of the [redacted] stock acquired in the [redacted] merger transaction less than [redacted] years after the merger was sufficient to break the continuity of interest otherwise present at the time of the merger. Second, you question whether the exchange of [redacted]'s stock for [redacted] stock and cash meets the continuity of interest test where, at least arguably, less than [redacted] of the consideration received for the [redacted] stock was in the form of [redacted] stock. Third, you question whether it was possible for [redacted] to actively conduct a trade or business immediately after the distribution of [redacted] to [redacted] as required by I.R.C. § 355(b)(1)(A) when [redacted] was immediately merged out of existence. Fourth, assuming that the general requirements of § 355(b) were met, you question whether the fact that [redacted] had acquired its interest in [redacted] during the [redacted] year period preceding the split off and merger has any effect on the tax-free nature of the merger transaction.

LAW:

I.R.C. § 354(a) provides that no gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are exchanged solely for stock or securities in another corporation. I.R.C. § 356(b) provides that, where §§ 354 or 355 would apply but for the fact that property other than property other than of the kind permitted to be received by those sections without the recognition of gain or loss is received, then gain will be recognized only to the extent of the sum of money and fair market value of other property received. The term "reorganization" is defined by I.R.C. § 368(a)(1) to include any one of six specific transactions described in that subsection including, as relevant here, statutory mergers under subsection (1)(A), and corporate divisions of the type described in subsection (1)(D).

A. Continuity of Interest

The continuity of interest test is based on the proposition that in a true reorganization, the shareholders of the acquired

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[8] While the returns of the former individual shareholders of [redacted] are not at issue here, we understand that the cash received by those individuals was currently recognized as § 356(a) "boot."

corporation have not terminated their economic investment, but have merely altered its form. As such, the test limits nonrecognition treatment to instances where the shareholders receive a proprietary stake in the continuing enterprise and where the proprietary interest so received represents a substantial part of the value of the property transferred. See, e.g., Penrod v. Commissioner, 88 T.C. 1415, 1428-1430 (1987) and cases cited therein.

1. The [redacted] sale of the [redacted] stock received in the [redacted] merger does not break the former [redacted]'s shareholders' continuity of interest because the merger of [redacted] into [redacted] was not contemplated at the time of the [redacted] merger.

In Penrod, a group of shareholders owning stock in numerous corporations owning and operating McDonald's franchises in South Florida (the "Penrods") agreed to let McDonald's acquire their franchises by merging the target corporations into McDonald's. The shareholders received unregistered McDonald's stock for their shares, together with piggyback rights and the further right to compel registration of their shares during a period commencing three months after closing and ending nine months later, all largely at McDonald's expense. The Court found, as a matter of fact, that McDonald's had insisted on a stock for stock exchange for financial accounting reasons, that the Penrods had never balked at this proposal or otherwise insisted on cash, and that the piggyback and demand registration rights were inserted in the merger agreement on the motion of the Penrod's attorney, who normally insisted on such provisions in agreements of this sort. Finally, the Penrods testified, and the Court so found, that none of the shareholders harbored any intent to sell their McDonald's shares at the time of closing, but only formed a desire to do so some time after closing. As a consequence, held the Court, the requirements of the continuity of interest test had been met and the transaction qualified for nonrecognition treatment.

The facts and holding in Penrod nicely contrast with the facts and holding of another case concerning the acquisition of McDonald's franchises, McDonald's Restaurants of Illinois v. Commissioner, 688 F.2d 520 (7th Cir. 1982), rev'g sub nom McDonald's of Zion v. Commissioner, 76 T.C. 972 (1981) ("McDonald's of Illinois"). In that case, like Penrod, McDonald's approached shareholders owning the stock of a group of companies owning McDonald's franchises with a view to acquiring them by merger. Unlike Penrod, the shareholders of the target corporations resisted, insisting on cash for their stock. The parties eventually agreed on a stock for stock deal, with the proviso that the McDonald's shares received in the exchange were to be sold in connection with a public offering of McDonald's stock scheduled to take place some three months later in June of 1973. Due to adverse market conditions, the June, 1973 offering was postponed to October of that year. In October, the shareholders sold their McDonald's shares.[9]

The Court of Appeals, reversing the Tax Court, held that the fact that the shareholders intended to dispose of their McDonald's shares at the first opportunity was dispositive and not, as held by the Tax Court, the lack of a binding commitment to sell the shares. In doing so, it rejected the Tax Court's interpretation of the "interdependence" version of the step transaction doctrine which, according to the 7th Circuit, the test is "practical and less legalistic than that." McDonald's Restaurants of Illinois, supra, 688 F.2d at 524.

The step transaction doctrine appears in a number of guises and is arguably one of the most important judicial doctrines employed by the courts in the corporate tax arena. It is applied to determine whether to give effect to the individual steps of a transaction or, in the alternative, to collapse or "step" the transaction together, providing, in essence, that an earlier step of a transaction needs to be analyzed in the light of those transactions or steps that follow it. This memorandum does not attempt to summarize the step transaction doctrine, or its many variants. We believe it is safe to conclude that, under the facts of this case, the Tax Court would find a tax free reorganization regardless of which test it applied. Regardless of whether you apply a strict "binding commitment" test of the sort applied in McDonald's of Zion,[10] a looser, "interdependence"

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[9] For tax purposes, McDonald's treated the merger as a taxable transaction, allocating the value of the shares exchanged among the assets of the companies so acquired and distributing the assets to a series of newly formed subsidiaries. The Service disagreed, determining that the merger qualified as a tax free reorganization and denying McDonald's a stepped up basis in the assets acquired.

[10] If the facts in the two McDonald's cases were applicable here, the Tax Court would be inclined to follow its own ruling because appeal of this case would lie to the 3rd Circuit, not the Seventh Circuit. Golsen v. Commissioner, 54 T.C. 742, 756-757 (1970), affd.445 F.2d 985 (10th Cir. 1971). In applying its own test to the instant set of facts, it would undoubtedly find for the taxpayer in the absence of a binding commitment on the part of the former [redacted] stockholders to sell their [redacted] stock. An option to sell stock in the future (or "put") is not a binding commitment by the option holder to sell.

test like that applied in McDonald's Restaurants of Illinois or the test applied in Penrod, there was no binding commitment in this case, nor is there any evidence that the former [redacted] shareholders expressed any interest in selling their [redacted] stock at the time of the merger.[11]

2. The amount of [redacted] stock received, expressed as a percentage of the total value of [redacted] prior to the split off and merger, was sufficient to meet the continuity of interest test.

In Helvering v. Minnesota Tea Co., 296 U.S. 378(1935), the Supreme Court held that the transfer of substantially all of a corporation's assets for voting trust certificates representing common stock and worth $540,000 and $425,000 in cash met the continuity of interest test because the shareholders of the transferor corporation acquired a "definite and substantial interest" in the purchaser. Five years later, the same court held that the transfer of the assets of a corporation in return for cash and bonds issued by the acquiring corporation breaks the necessary continuity. LeTulle v. Scofield, 308 U.S. 405 (1940). The general rule, at least for ruling purposes, seems to be that a transfer of all of a corporation's stock in a statutory merger will meet the continuity of interest test where the shareholders of the disappearing corporation receive at stock in the acquiring corporation worth at least 50% of the assets transferred. See Rev. Rul. 66-224, 1966-2 CB 114; Rev. Proc. 77-37, 1977-2 CB 568.[12] The Supreme Court apparently considers 38-percent equity continuity to be sufficient. John A. Nelson Co. v. Helvering, 296 U.S. 374 (1935).

The Letter of Intent signed by the parties and dated [redacted] valued [redacted] at $[redacted], and provided that [redacted] and the individual shareholders would receive $[redacted] in cash and [redacted] stock subject to potential adjustments. One of these adjustments was based on the possibility that the [redacted] liabilities might fall below $[redacted] between the date of the letter agreement and the closing date. The [redacted] debt did fall during this period, and as a result of this and other adjustments agreed to by the parties, the "Merger Consideration," consisting of the [redacted] stock and cash to be distributed to [redacted]'s shareholders in return for their stock, was increased in the

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[11] For a third case involving similar facts, see Estate of Christian v. Commissioner, TC Memo. 1989-413.

[12] For the continuing authority of Rev. Proc. 77-37, See Rev. Proc. 2001-1, I.R.C. 2001-1, 1.

amount of slightly over $[redacted]. Pursuant to the parties' agreement, [redacted]'s share of this adjustment was to be paid in stock, and the individual shareholders' shares in cash. As a result, [redacted] received [redacted] stock with a fair market value of slightly over $[redacted], while the individual shareholders received [redacted] stock worth $[redacted] and $[redacted] in cash. The value of the stock received, expressed as a percentage of the total consideration received by the [redacted] shareholders in connection with the overall merger transaction, was slightly in excess of [redacted]% of the total.[13]

B. <u>[redacted] was actively engaged in a trade or business after the split off of [redacted] despite the fact that it was almost immediately merged out of existence</u>.

In <u>Mary Archer W. Morris Trust</u>, 42 T. C. 779, 791 (1964), affirmed 367 F. 2d 794 (4th Cir. 1966), American, a State chartered bank, desired to merge into Security, a federally chartered or "National" Bank. The merger was initially impeded by the fact that State was engaged in the active conduct of selling insurance in addition to its banking activities. National banks were prohibited from conducting an insurance business under federal law, so it was agreed to spin off the insurance business to the shareholders of American followed by a consolidation of American and Security under Security's federal charter.

The Service attacked the tax free nature of the spin off, on a number of grounds, only one of which is germane to this case.

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[13] While Rev. Proc. 77-37 requires that consideration received by shareholders in connection with other transactions incident to the overall plan be considered in determining overall continuity, and while we have so included the $[redacted] in [redacted] stock received by [redacted] in redemption of a portion of its [redacted] stock prior to the merger of [redacted] into [redacted], and while we also have excluded the $[redacted] from the equity computation in determining that a little over [redacted]% of the value of [redacted] before the overall transaction was converted into equity in [redacted], this begs the question of whether the continuity represented by [redacted]'s continuing investment in one of [redacted]'s businesses, that dropped into [redacted] and distributed to [redacted], should be considered in determining continuity. If it should be so considered, then the value of the [redacted] and [redacted] stock received by [redacted]'s shareholders increases from [redacted]% to over [redacted]% of the total consideration received. Since this memorandum concludes that the continuity of interest test is met regardless, we reserve this question for another day.

Noting that for the spin off to qualify under § 355(b), both the distributing corporation and controlled corporation must be engaged in the active conduct of a trade or business after the distribution of the controlled corporation's stock, the Service reasoned that the distributing corporation, American, did not meet this requirement because it ceased to operate under its own charter after its consolidation with Security. The Tax Court agreed, noting that the consolidation was governed by the National Banking Act which provided that for banks consolidating under those provisions, the banks "shall be merged into and continued in the consolidated banking association." The surviving entity, under the National Banking Act, was considered to be "the same corporation as each bank or banking association participating in the consolidation," and the tax free nature of the organization upheld. In sharp contrast are the merger provisions of most, if not all state corporation laws which generally provide, as did the merger agreement here, that the acquired company in the merger disappears with the surviving corporation succeeding to the target corporation's assets and liabilities.

Notwithstanding the apparent factual distinction between the special case represented by the facts in the Morris Trust case and the general case represented by the facts here, subsequent rulings have largely, if not completely, buried the distinction between a consolidation under the National Banking Act and a merger under state law. See Rev. Rul. 68-603, 1968-2 C.B. 148; Rev. Rul. 70-434, 1970-2 C.B. 83; Rev. Rul. 72-530-2 C.B. 212. This treatment seems justified by the opinion of the Fourth Circuit on appeal, where the Court held that a literal reading of the "immediately after the distribution" language of § 355(b)(1) "will not inhibit continued stockholder conduct of the active business through altered corporate form and with further changes in corporate structure, the very thing the reorganization sections were intended to facilitate." Commissioner v. Morris Trust, 367 F.2d 794, 798-799 (4th Cir. 1966), quoted in Rev. Rul. 78-251, 1978-1 C.B. 89.

The short of it is that a split off or other corporate division followed by a merger of the distributing corporation into an acquiring corporation does not cause the distributing corporation to fail the "active conduct of a trade or business" test of § 355(b)(1) because, at least for a brief moment in time, the test is met - apparently all that is necessary to implement the full bevy of protections imbued in § 355.

C. The Recent Acquisition of [redacted] Stock by [redacted]

As noted above, [redacted] acquired its [redacted] stock by purchase in [redacted] separate transactions taking place between [redacted] and [redacted]. The examining agent has questioned, in passing, whether the fact that [redacted] had acquired its [redacted] stock by purchase during the 5 year period preceding the split off and merger might have an effect on the tax free nature of the overall transaction. The answer is yes.

§ 355(d)(1) provides, in the case of a "disqualified distribution," for the recognition of gain on the distribution of "disqualified stock" in a transaction otherwise qualifying under § 355. § 355(d)(2) defines "disqualified distribution" where any person holds "disqualified stock" in either the distributing corporation or a controlled corporation in a § 355 transaction and where the interest so held constitutes a 50% or more interest in such corporation. § 355(d)(3)(B) defines "disqualified stock" as including stock in controlled corporation received in a distribution attributable to stock in a distributing corporation acquired by purchase within the five year period immediately preceding the distribution. [redacted] acquired its [redacted] stock during the 5 year period preceding the split off and merger. The stock of [redacted] distributed to [redacted] was "attributable" to the [redacted] stock. The distribution of [redacted] stock to [redacted] was a "disqualified distribution" and [redacted] should have recognized gain to the extent the fair market value of the [redacted] stock, pegged at $[redacted] under the merger agreement, exceeded [redacted]'s basis in [redacted]. See Reg. § 1.355-6, Ex. 3.[14]

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[14] [redacted] was never a member of the taxpayer's consolidated group and, as such, its tax liabilities are of no concern to it. On the other hand, the examining agent made attempts to secure a copy of [redacted]'s return for the period in question but was unable to do so. A review of [redacted]'s transcript for the period in question shows a long term capital gain of $[redacted], an amount fully consistent with the gain it might be expected to have realized on the distribution. In view of the foregoing, no further action seems indicated.

Conclusion:

This concludes our advice in this matter. We are forwarding a copy of this memorandum to our national office for mandatory ten day post review. Please refrain from taking any final action in this matter for a period of 15 days in case we receive contrary advice from our national office.

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